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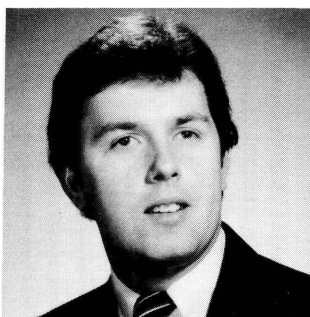
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MERGERS AND ACQUISITIONS: CHARACTERISTICS AND CONTROVERSIES OF THE PRESENT WAVE

Robert T. Wright



I. Introduction

Because of relentless foreign competition and the need to form more economically sound and manageable companies, a merger wave has developed in the U.S. in the past few years. This merger wave, which originated after the recession of 1973-75, is one of four distinct surges of merger activity that has occurred in the U.S. The first was during the period of 1895-1905 and was characterized by the formation of horizontal mergers. During this period, the business world saw the formation of such giants as DuPont, U.S. Steel and other single industry firms. The second surge occurred in the 1920s. The focus this time was on the vertical integration of many industrial firms along with the formation of many utility companies. This period's activity eventually dissipated with the onset of the Great Depression.

The next surge of merger activity occurred after World War II. Beginning in the late 1950s, merger activity became most vigorous during the period of 1960-69. Unlike the previous two merger waves, however, these mergers

emphasized the diversification of acquisitions and the growth of conglomerates. Still, despite a record number of more than 6,000 merger transactions involving a total value of \$24 billion in 1969, many of the larger U.S. corporations were not involved. It was not until the fourth wave of mergers which began in 1975 that many of the larger corporations became caught up in the merger "frenzy." Along with the participation of these larger corporations also came much larger dollar transactions. Although the year 1979 witnessed only 2,128 acquisitions, their dollar volume (\$44 billion) was \$20 billion greater than that generated by the 6,000 mergers in 1969! In fact, every one of the ten largest U.S. acquisitions was formed during the present merger wave. Furthermore, the mergers which mark the present trend are more likely to involve similar businesses and, unlike the acquisitions of the 1960s, seem to favor long-run corporate growth (Bradley & Korn, 1981, p. 7).

To a large degree the continuation of the present wave has been fueled by the Reagan

Administration's "anti-anti-trust" policy, one which has convinced many companies to jump on the merger bandwagon while the window of opportunity is still open. However, this "laissez-faire" attitude of the Reagan Administration is currently being severely tested by some of the new controversies surrounding today's acquisitions. Such controversies have deflated the image of American business in the minds of many people and threaten to undermine its respectability.

It is the purpose of this paper to explore in greater depth the unique aspects of the current merger boom. The paper will focus on controversial takeover tactics and defenses along with the new public policy issues which have been raised. It will also touch upon the new reasons for the upsurge in merger activity.

II. Motives for the Merger Trend

In the current merger boom, no company seems immune from being considered as an acquisition candidate. Good potential acquisitions are usually considered by acquiring companies for the following objectives:

1. Greater economies of scale,
2. Geographical expansion or growth in asset bases,
3. Good future cash flows,
4. Diversification.

Still, in general, the best takeover candidate is a company not living up to its potential, that is, a company whose stock is undervalued relative to its potential for future growth. For example, retail stores have recently become very attractive acquisition candidates because their stock prices (which were so depressed about a year or two ago) have begun to recover and because their rents and leases as stated on their books grossly understate their real values. Furthermore, retail stores are comprised of various divisions which can easily be sold to generate cash. Most retail stores also offer the additional benefit of possessing a wide distribution of stock. This makes the acquisition of shares easier than if the stock were concentrated in one large block as in the case of family ownership (*Chain Store Executive with Shopping Center Age*, 1984, p. 20).

Until recently, such primary business objectives as those mentioned above were considered sufficient in evaluating the possibility of a merger. However, faced with a more volatile and perplexing economy, some companies have devised new reasons for deciding to acquire businesses. For instance, many companies have discovered that a merger can be a relatively inexpensive way of acquiring new assets. This thinking has become especially prevalent in the oil industry. With reserves sinking each year, many companies find it more profitable to buy out smaller companies and capture their reserves rather than to drill for new oil. One well-known advocate of this practice is T. Boone Pickens, Chairman of Mesa Petroleum Company. Pickens points to the dismal prospects of replacing oil reserves through domestic exploration and the rising cost of drilling as reasons for mergers (*Wall Street Journal*, March 12, 1984, p. 28). In addition, the declining price of oil has further reduced the incentive needed to start up new drilling activity. Accordingly, these problems have depressed oil company stock prices and have made the companies even more susceptible to takeover.

Critics of this merger movement by the oil companies argue that the takeovers diminish the amount of new oil found by the U.S. since they divert dollars away from actual exploration. This only serves to increase the acquiring company's reserves while keeping total reserves the same. The critics point out further that such activities could cause an even greater dependence on foreign imports which, coupled with reduced competition in the U.S. markets, could lead to potentially higher prices for crude oil in the future (*Wall Street Journal*, March 7, 1984, p. 24).

There is a second new reason for some of today's merger activity. Companies in failing industries are now considering mergers as a means of survival. One notable example is the approved merger between LTV Corporation and Republic Steel Corporation in March of 1984. The merger approval came only five weeks after the Justice Department originally declared that the LTV-Republic merger would result in an "unacceptably high" concentration in several areas of production. The Department

later reversed its ruling under the condition that the companies agree to liquidate two Republic Steel plants. Both merger partners contended that the newly consolidated company would create efficiencies that will enable the company to compete more effectively in the world steel market by reducing annual costs by more than \$300 million (*Wall Street Journal*, March 9, 1984, p. 33).

III. Leveraged Buyouts

One device which has helped spur on the increasing number of takeovers with progressively greater dollar volume is the leveraged buyout (LBO). The LBO is a merger tactic whereby the acquiring company or investors borrow a large amount of money in order to finance the amount needed to purchase another company.

One of the main reasons for the upward trend in LBOs is the Economic Recovery Tax Act (ERTA) of 1981. ERTA's impact can be most easily seen in a situation where an LBO is used by management to buy control of its own company. Typically, management will use this type of buyout to eliminate the possibility of an accumulation of stock by unwanted investors or to consolidate control. By borrowing heavily against corporate assets, a small group of managers or investors can take full advantage of favorable depreciation rules in the tax code. With the passage of ERTA, the company can take advantage of accelerated depreciation of the assets acquired to reduce taxable net income. The resulting increase in free cash flows and liquidity can then be used to service and quickly retire the debt incurred in the buyout (Mancuso & Ferenbach, 1984, pp. 20-22). Other tax advantages have also encouraged acquisitions through leveraged transactions rather than through the direct exchange for another company's stock. By borrowing the needed cash, the acquiring firm is able to deduct the interest incurred by the debt from taxable income. On the other hand, should a stock transfer be made, dividends must be paid from the acquired stock out of after-tax income, which are then taxed again as income to

the recipients (*Wall Street Journal*, July 21, 1984, p. 34).

Another reason for the increasing use of LBOs is the ready availability of LBO financiers. These are investment bankers who supply the capital needed for the takeover and, in turn, usually receive an interest in the company along with a rather large fee for arranging the acquisition. For example, in Nestle's \$3 billion agreement to purchase Carnation, Kidder, Peabody and Company received \$15.3 million in fees for advising Carnation and First Boston Corporation received \$7.5 million for guiding Nestle. Also, a total of \$63 million was paid to Solomon Brothers, Merrill Lynch, and Morgan Stanley for advising Gulf Oil Company and Standard Oil Company of California in their \$13.4 billion combination (*New York Times*, September 30, 1984, Section III, p. 1). Such fees have caused critics to complain that investment bankers have an incentive to go out of their way to find a corporate suitor for an acquiring firm in an LBO transaction regardless of the economics of such an acquisition. As Felix Rohatyn from Lazard Freres & Company has stated, "Corporate customers look at the investment bankers not as advisors, but as people peddling companies" (*New York Times*, September 30, 1984, Section III, p. 1).

Critics also point to several negative repercussions which result from LBOs. For instance, because a corporate acquisition through an LBO requires heavy borrowing, a primary concern for the acquiring company is reducing this debt. Typically, this is done by using the money generated from the acquired company's operation or from the sale of its assets. When this need for cash is combined with opportunities for eliminating overlaps, there are great incentives to sell off some assets of the acquired company after the acquisition. This can also lead to sizeable layoffs of the acquired firms' workforce. For example, when Texaco acquired Getty Oil Co. for \$10.1 billion, it sold off at least \$1.6 billion of Getty's assets to eliminate overlaps and to pay off some of its debt. Texaco also stated that it would probably have to reduce the workforce by 20 percent by 1985 (*The Economist*, 1984, p. 69). Such layoffs tend to alienate employees of the newly acquired company and

may cause subsequent morale problems within the organization.

Notwithstanding these internal difficulties, the main risk involved in an LBO is the amount of leveraging itself. One of the problems with leveraging is that the net effect of the debt to a normal corporation is dangerously magnified because of the company's highly leveraged position. In other words, the more highly debt-laden or leveraged a firm is, the greater also is the volatility in the firm's profitability. As a result, leveraging may be used to boost stockholder returns, but it is used at the risk of increasing losses if the firm's economic fortunes should subsequently decline (Brigham, 1982, p. 376). Just such concerns led SEC Chairman John Shad in 1984 to be the first high-ranking government official to express his personal worry over the increasing number of LBOs. He claimed that numerous bankruptcies would arise from the rising tide of leveraged takeovers if interest rates soar or if the economy slips into a recession (*Wall Street Journal*, June 8, 1984, p. 8). These same sentiments were echoed by Federal Reserve Board Chairman Paul Volcker, who warned that LBOs may expose debt-laden acquisitions to harsh financial difficulties. Volcker also pointed out yet another growing concern over LBOs—that the large loans made by the banks to support such mergers can restrict available credit for other purposes or even cause an increase in interest rates through a "crowding out" effect (*Wall Street Journal*, July 14, 1984, p. 4).

Still another serious problem with LBOs is that companies that use them to purchase other companies are usually hard pressed to continue normal competitive operations. Growth prospects may be limited by capital constraints, at least in the early years of the buyout. Furthermore, competitors may increase the level of price competition in the market in the knowledge that the newly leveraged company needs to generate cash to service debt and will be reluctant to cut its prices. Therefore, the success of an acquisition through an LBO ultimately depends on management's proper evaluation and forecasting of future cash flows to service the debt (Mancuso & Ferenbach, 1984, pp. 20–22).

IV. Defensive Tactics

The development of new merger incentives, the LBO, and the Reagan Administration's present attitude of "laissez-faire" towards mergers have all resulted in many controversial takeover battles, most of which are the consequence of hostile acquisition efforts. A hostile acquisition is an attempt by one company to take over another company without the favor or the consent of the latter. These attempted mergers are often the scene of aggressive takeover tactics by the acquiring company and sometimes controversial defense maneuvers used by a resisting target company, as I will describe below.

The acquiring company may first try to acquire the target company through a tender offer, whereby it offers to buy the company's stock for a stated sum from stockholders who tender their shares. If this is met by opposition from the targeted company, which is normally the case in a hostile acquisition, the acquiring company may then revert to a proxy fight. A proxy fight occurs when dissenting shareholders or those seeking control solicit the votes of a corporation's shareholders to gain seats on the board of directors. In this way, the acquiring company can take control of the target company and be able to direct its actions along the course it desires. The proxy fight is a major tactic used by small companies or individuals to fight larger opponents. Not only can the proxy fight clear the way for a merger, but it can also be used as a tool for increasing the company's value by authorizing the sale of some of its assets or for getting rid of allegedly inept management (*New York Times*, January 15, 1984, p. 1).

Considering the consequences of these aggressive takeover tactics (LBO or tender offer), many companies are wary of being a targeted company in a hostile acquisition and are implementing sometimes controversial defense systems to avoid such occurrences. The number of corporations undertaking such anti-takeover measures in 1984 was more than double that of the previous year. It was also estimated that in 1984 one-third of all publicly held companies took some action at their annual meetings to

secure greater protection against hostile takeovers (*New York Times*, April 8, 1984, p. 4). The principal objectives of these defensive maneuvers are to make the acquisition of the company seem less attractive, too difficult or simply too expensive. The defensive tactics that have been used to drive off hostile pursuers have been given some imaginative names. For example:

1. "Scorched earth"—This is a defensive strategy whereby the targeted company tries to discourage a takeover by making itself appear less attractive. This can be done, for example, by selling off some of its most sought after assets.
2. "Pac-man"—This is a defense maneuver which changes the roles of the companies with the target company turning around and trying to take over the original pursuer. Although the attempted takeover may not be successful, it is hoped that it will deter the original pursuer from seeking further action (Greenwald, 1985, p. 55).
3. "Poison pill"—This is a tactic which makes the takeover more expensive than it's worth. This might entail the issuance of more preferred stock with special voting rights and veto power to a limited class of friendly shareholders or employees. It may also involve the issuance of new securities that can be turned in for cash or converted into debentures if the unwanted takeover is successful.
4. "Shark repellent"—Among the many shark repellent proposals, which normally take the form of charter amendments, are the following:
 - a) staggered terms for board members, which prevent hostile parties from gaining control of the board;
 - b) fair-pricing, which assures that all stockholders receive the same payments for their stock;
 - c) supermajority requirements, which stipulate that an approval of a merger requires not a simple majority, but rather a decisive majority of 70% or more (*New York Times*, April 8, 1984, p. 4).

5. "Golden parachute"—This is a guarantee of large payments or bonuses to corporate executives in the event their company is taken over, in order to compensate those top executives who are fired or placed into a subordinate role. However, there are no agreements to protect other employees and stockholders.

6. "White knight"—An alternative to being acquired by a hostile pursuer, the white knight is a "friendly" acquiring corporation which comes to the aid of another corporation faced with a hostile takeover fight. The knight agrees to retain both management and the current workforce (Greenwald, 1985, p. 55).

To the above list of defensive tactics should be added "greenmail," probably the most controversial of all the tactics used by a targeted company to prevent a hostile takeover. Greenmail occurs when a hostile investor buys up a sizeable portion of the target company's stock, but the target company, desperate to get rid of the investor's threatening presence, proceeds to buy back the investor's shares at a premium above the market price. The target company feels this premium is necessary to assure the protection of the company against any potential future takeover battles. However, greenmail usually depresses the value of the target company's stock and therefore imposes a cost on friendly stockholders. As a result, there have been cases of stockholders' suits against management for providing greenmail, on the grounds of corporate waste and the payment of inequitable premiums. Still, the real profiteers are the so-called "corporate raiders," who secretly buy up a substantial portion of a company's stock and purposely impose a takeover threat in order to profit from possible greenmail gains (*Wall Street Journal*, May 2, 1984, p. 33).

The use of these offensive tactics and defensive maneuvers can sometimes lead to long and hard-fought takeover battles. Such battles not only tend to have disruptive effects on the companies involved, but can also tarnish the image of the U.S. business world as a whole.

Typically following a takeover battle, there arises in the minds of the public the impression that the struggle was motivated more by the personal ambitions of the company's executives than by the best interests of the company and its stockholders.

V. Public Policy

In light of some of the negative effects and potential dangers emanating from the current merger wave, some government agencies have initiated proposals to impose further regulations upon certain types of merger activity. At the present, the Securities Exchange Commission (SEC), the Congress, and the Reagan Administration are not in agreement on the appropriate measures that should be taken to ensure healthier and economically sound mergers. Congressional representatives have proposed legislation to curb hostile takeovers, while the SEC has moved in the opposite direction in backing changes that would restrain a company's efforts to resist takeovers. The Reagan Administration has opposed various House bills designed to outlaw certain defensive tactics in acquisition battles and instead seems content to let things remain as they are without government interference.

The SEC has proposed the following regulations to prohibit certain anti-takeover tactics:

1. Banning "golden parachutes;"
2. Outlawing target companies from making tender offers for their own stock;
3. Requiring stockholder approval before "greenmail;"
4. Prohibiting the issuance of new securities during tender offers or proxy fights without shareholder consent (preventing "poison pills");
5. Adopting measures which would require a person who acquires 5% or more of the company's stock to cease acquiring additional shares until 10 days after filing a disclosure of the acquisition with the SEC. (This is an effort to prevent "sneak attacks" by hostile bidders who rush to buy as many shares as possible in the 10-day interval before having to

publicly report their holdings to the SEC.) (*Wall Street Journal*, May 10, 1984, p. 7).

Other proposals have been made by Congressional representatives which have been supported by the SEC. Such proposals include a bill which would prohibit a company from repurchasing a stockholder's shares at a premium unless the investor has held the stock for at least two years or unless the repurchase is approved by a majority of the shareholders. Still another Congressional proposal would require hostile investors either to purchase less than 10 percent of the company's total stock (in which case the target company would have no incentive to offer greenmail) or to make a serious offer for the entire company (*Wall Street Journal*, May 2, 1984, p. 33).

On the other side of the Atlantic, the British have also become increasingly concerned with their own growing number of hostile takeovers. To reduce the percentage of takeovers which are contested (estimated to be as high as 30 percent), the British are attempting to revise their code on mergers to alleviate two particular troublesome areas. One such revision concerns the speed of purchases. The proposed revision would allow buyers to purchase stock more quickly by permitting them to accumulate up to 10 percent of the voting shares in any seven-day period rather than only 5 percent according to current regulations. This proposal would also eliminate the seven-day ban on an acquiring company's securing additional shares after the takeover bid has been made. Another proposed regulation would limit the ability of acquiring companies to pressure stockholders by threatening to close the tender offer at a fixed date. According to the proposal a tender offer would have to remain open for at least 14 days after the bid becomes unconditional. The objective of these and other proposed revisions is simply to ensure that British stockholders are treated "fairly" in a merger situation. The rules would also help to decelerate the pace of contested takeover bids by giving the investors time to reflect upon their decision (*The Economist*, 1985, pp. 86-88).

VI. Conclusion

In light of the potentially costly and disruptive effects emanating from today's merger wave, it seems clear that some measures must be taken to ensure more economically sound and less hostile combinations. Far too many companies appear to be more concerned simply with the present accessibility and ease of such acquisitions rather than with the actual

benefits that might be gained from them. Concurrently, the paranoia of becoming a targeted company has caused some firms to concentrate more on implementing defenses against hostile takeovers than on their own business operations. It has not been our purpose to evaluate the relative worth of the proposals now being discussed; however, it is clear that it is only a matter of time until a more rational regulatory framework is provided.

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